SUPREME COURT OF THE UNITED STATES

October Term, 1927.

No. 156.

L. M. WILLCUTS, COLLECTOR OF INTERNAL REVENUE for the District of Minnesota, Petitioner.

vs.

MILTON DAIRY COMPANY.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

BRIEF ON BEHALF OF RESPONDENT.

THE QUESTION.

The question in this case is: Must the deficit incurred prior to the enactment of the Excess Profits law be replaced before the net earnings for years subsequent to the enactment of the law can be added to the invested capital?

THE STATUTE.

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1092.

Sec. 326. (a) (so far as relevant to the question in this case, provided):

> That as used in this title the term "invested capital" for any years means * * *
>
> (1) Actual cash bona fide paid in for stock or shares.
>
> (2) Actual cash value of tangible property other than cash, bona fide paid in for stock or shares * * *.
>
> (3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year.

STATEMENT.

Prior to the enactment of the excess profits tax law, respondent suffered operating losses impairing its capital, $70,296.12. Pursuant to that law the Commissioner of Internal Revenue, as of February 28, 1917, fixed the amount of respondent's invested capital as $145,817.04, this being the cost of the original investment, and thus the amount upon which respondent was entitled to earn 8% before the extraordinary excess profits and war profits taxes applied. During each of the three years immediately following the enactment of the excess profits tax law, respondent operated at a profit. These net earnings were not paid out in dividends, but were left in the business undivided.

There was no operating loss in any of these years.

SUMMARY OF ARGUMENT.

Invested capital is a creation of the Revenue Act to exempt certain income from excess profits and war profits taxes, to relieve the taxpayer of part of the burden of these extraordinary taxes, and the Act gives the respondent a right to add to the invested capital certain earnings left undistributed in the respondent's business.

There is nothing in the Revenue Act requiring such earnings to be applied in reduction of an operating deficit incurred prior to the enactment of the excess profits tax law.

Undivided profits having been determined as of annual accounting periods, the profits so ascertained taxed under the Revenue Act, and left undistributed in the business, there being no subsequent operating deficit, are undivided profits under Sec. 326 (a) (3).

The Treasury Department cannot, by construction or regulation, impose a tax burden not imposed by the Revenue Act itself.

ARGUMENT.

The question involved in this case is met and answered in the opinion of the Circuit Court of Appeals and we will not burden this Court with another version of reasons so clearly and emphatically given in that opinion.

The Circuit Court of Appeals correctly decided the case.

The Government prevailed in *Edwards v. Douglas*, 269 U. S. 204, the Government's contention there being, as stated by the Court:

> "The Government contends that the phrase "most recently accumulated *undivided profits* or surplus" in section 31 (b) *includes current earnings of the year* in which the dividends are paid; and that, as the earnings of 1917 were ample to pay these dividends, the 1917 dividends are conclusively presumed to have been paid out of 1917 earnings." (Italics ours.)

This Court will not permit the Government to "blow hot and blow cold" in its definition of undivided profits, that it may impose a tax by one definition and by another definition deprive a taxpayer of the slight relief from excess profits and war profits taxes expressly granted by the statute.

This respondent contends that the words "undivided profits" in Section 326 (a) (3) expressly make annual earnings of respondent, on which the taxes imposed by the Act have been paid, a part of respondent's invested capital.

There is nothing in the petitioner's brief to take away from or in any way modify the definition of undivided profits in *Edwards v. Douglas*, supra, quoted in the Circuit Court of Appeals decision.

The lack of any real authority to support petitioner's argument is shown by the cases cited in its support.

Two are decisions of the Board of Tax Appeals:

Appeal of Valdosta Grocery Co., 2 B. T. A. 727, seems to have been decided on authority of the decision of the District Court in the present case, which decision is now before this court.

Appeal of Gould Coupler Co., 5 B. T. A. 499. This case is not at all in point applying as it must only where several corporations are affiliated and treated as a unit for income and excess profits tax purposes.

Decisions of U. S. District Court and Circuit Court of Appeals, respectively, cited by petitioner:

Insurance Company of North America v. McCoach, 218 Fed. 905,

Leather Manufacturers' National Bank v. Treat, 116 Fed. 774,

are not in point, as neither case requires or has any definition of undivided profits.

Nowhere in petitioner's argument is there anything to show what the money, $11,489.26 and $22,908.14, earned in the fiscal years ending in 1918 and 1919 is if it is not undivided profits, and all of the academic discussion of bookkeeping terms cannot take away the solid fact—unaffected by bookkeeping terms—that over $34,000 was earned by respondent, taxed by the government, and left in the respondent's business.

All the argument in petitioner's brief cannot take this fact out of the case, nor change the fact that this money so earned and left in the business is exactly what Congress

intended to be a measure for some relief to the taxpayer when it provided in Section 326 (a) (3) that "undivided profits" are to be added to invested capital.

Undivided profits must be determined as of annual accounting periods.

The Revenue Act of 1918 required the Dairy Company to ascertain its net income in each fiscal year.

Sec. 212 (b):

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer * * *."

The law makes each year a unit within which is determined whether or not there is taxable income. The Dairy Company has so ascertained its net income for each of the years in question, and it follows as a matter of course that net income on which it has paid income and excess profits tax and which income remained in the business is undivided profits.

No better digest of the decision of the Circuit Court of Appeals in our case and of the respondent's contention can be made than the statement in petitioner's brief (p. 11):

> "The underlying principle of the "excess" profits tax was that the taxpayer should be allowed, free of the tax, a reasonable return fixed by the statute on his investment *and what had been added to it by accumulations of profits.* See LaBelle Iron Works v. United States, 256 U. S. 377." (Italics ours.)

With such a clear understanding of the purpose and effect of Section 326 (a), the Commissioner is acting in

an arbitrary and illegal manner in refusing to add to respondent's original investment $34,397.40, being profits earned after the enactment of the law, which profits have been subjected to the income, excess profits and war profits taxes imposed by the same law.

Petitioner's argument is devoted to a discussion of bookkeeping terms.

The act does not make mere bookkeeping entries the test of invested capital.

Congress wholly ignored these in creating invested capital in Sec. 326 (a).

The law looks to the substance—the cost of original investment—the amount of money later paid in—the money earned and left in the business.

If on the enactment of the law, respondent's articles of incorporation had been amended—a simple and inexpensive proceeding—and respondent's capital thereby reduced by cancellation of $75,000 of its stock, the resulting book entries and balance sheet would have eliminated the deficit of $70,296.12 and instead there would have appeared a surplus of almost $5,000. The balance sheet would show "excess of assets over liabilities (including capital stock") and so meet the test in petitioner's brief (pp. 7, 8, 9, 10, 14).

If the capital had been so reduced, the Commissioner would still fix the invested capital at $145,817.04, as that was the cost of the original investment.

If the stockholders had paid $34,397.40 in cash into the company after the capital had been so reduced, that amount would certainly have been added to the invested capital.

When respondent earned $34,397.40 in cash and left it undivided, would petitioner claim this sum must be applied to make up the amount by which the capital had been reduced by amendment of the articles and cancellation of stock?

That the Commissioner is wrong in his insistence that the balance sheet is controlling, and not the fact of the amount of money invested and earned and left in the business, is decided in *LaBelle Iron Works v. United States*, 256 U. S. 377, where stock issued to evidence an actual appreciation in value of almost Ten Million Dollars was held not to be a factor in determining invested capital.

Respondent has asked the Courts to reverse the Commissioner's ruling and the regulation of the Treasury Department, and now claims that petitioner should not urge the Department's practice as ground for reversal of the Circuit Court of Appeals.

Nothing in petitioner's brief attempts to justify the Commissioner except that Regulation 45 (1920 Edition) Article 838 is cited.

This regulation is merely a Departmental interpretation of the law and is not sufficient authority to take away from respondent a right given by the law itself. There is nothing in the Revenue Act requiring earnings to be applied against respondent's operating deficit.

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen."
>
> *Gould v. Gould*, 245 U. S. 151.

Section 326 (a) (3) is in clear, positive and unambiguous language, and the law there includes as part of "invested capital":

> "3. Paid-in or earned surplus and *undivided profits;* not including surplus and undivided profits earned during the year."

Did Congress say to all corporations whose capital was impaired at the time the law took effect:

> "You will not be allowed to have the 8% excess profits credit on your earnings left undistributed until your impaired capital has been made good?"

We do not believe it was intended to so penalize the corporation which, with the handicap of impaired capital, earned profits yielding income, excess profits and war profits taxes to the government.

Respondent was not relieved from taxation on its earnings (left undistributed) until its impaired capital was restored, but the Act required it to report these earnings at the end of each year as *profits* and pay taxes thereon at the highest rate known in this country's history.

The tax is imposed upon net income and profits of each taxable year; invested capital is the cost of the original investment plus subsequent additions. Previous operating loss is not a factor to be considered in ascertaining taxable *profits*, nor can it be a factor in fixing the amount of invested capital.

The "clear import" of the statute which levies an excess profits tax on this $34,297.40 does not require impaired capital to be replaced before allowing in following years the reasonable return of 8% upon the identical amount upon which income and excess profits taxes were levied and collected.

For the reasons stated, it is therefore most respectfully submitted that the judgment of the Circuit Court of Appeals is correct and should be affirmed.

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